

Dated: July 17, 2020



*Daniel P. Collins*

Daniel P. Collins, Bankruptcy Judge

**UNITED STATES BANKRUPTCY COURT  
DISTRICT OF ARIZONA**

<b>In re:</b>	)	Chapter 7 Proceedings
	)	
<b>SANDRA J. TILLMAN,</b>	)	Case No. 3:19-bk-01074-DPC
	)	
<b>Debtor.</b>	)	Adversary No. 3:20-ap-00038-DPC
<b>LAWRENCE J. WARFIELD,</b>	)	
<b>TRUSTEE,</b>	)	<b>UNDER ADVISEMENT RULING RE:</b>
	)	<b>MOTION FOR SUMMARY</b>
<b>Plaintiff,</b>	)	<b>JUDGMENT</b>
	)	
<b>vs.</b>	)	
	)	<b>[NOT FOR PUBLICATION]</b>
<b>UNITED STATES OF AMERICA,</b>	)	
	)	
<b>Defendant,</b>	)	
	)	
<b>and</b>	)	
	)	
<b>SANDRA J. TILLMAN,</b>	)	
	)	
<b>Defendant – Intervenor.</b>	)	

Before this Court is the Motion of Lawrence J. Warfield (“Trustee”) for Summary Judgment regarding whether the Trustee can avoid a tax lien (“Tax Lien”) under 11 U.S.C. § 724(a)<sup>1</sup> and, if avoided, whether the avoided lien is preserved for the benefit of the estate or for Sandra J. Tillman (“Debtor”) and what rights the United States of America (“IRS”) holds against the Debtor’s homestead or proceeds from the sale of that property. As

<sup>1</sup> Unless indicated otherwise, statutory citations refer to the U.S. Bankruptcy Code (“Code”), 11 U.S.C. §§ 101-1532, and to the Federal Rules of Bankruptcy Procedure, Rules 1001-9037.

1 Debtor's counsel correctly noted at oral argument, the issues before this Court have not  
2 been squarely resolved in this Circuit.

3 The Trustee contends the Tax Lien may be avoided under § 724(a) and the value  
4 of the avoided lien preserved for the benefit of the estate pursuant to § 551. The Debtor  
5 and IRS both contend the Trustee may not avoid the Tax Lien for the benefit of the estate.  
6 If the Tax Lien is avoided, Debtor argues she is entitled to claim an exemption in the  
7 avoided Tax Lien pursuant to § 522(g). The IRS argues its surviving claim must be paid  
8 from any distribution to the Debtor from the sale of the homestead. Apparently believing  
9 the IRS will get its pound of flesh one way or the other, the Debtor and IRS together  
10 oppose the Trustee's motion

11 On June 19, 2020, this Court heard oral argument on this matter. Having heard the  
12 parties' arguments and having reviewed their briefs, this Court now holds there exists no  
13 genuine issue of material fact and the Trustee may avoid the Tax Lien for the benefit of  
14 the estate pursuant to § 551. The Debtor is only entitled to claim as exempt value over and  
15 above the voluntary 1<sup>st</sup> lien and the involuntary IRS lien against her residence. After  
16 avoidance of its Tax Lien, the IRS holds an unsecured (but possibly nondischargeable)  
17 claim against the Debtor in the amount of the avoided Tax Lien. The Debtor may not  
18 employ §522(g) because the Debtor may not exempt that portion of the value of the  
19 Property occupied by the Tax Lien, whether that Tax Lien is held by the IRS or is avoided  
20 and then held by the Trustee for the benefit of this bankruptcy estate. Trustee's Motion for  
21 Summary Judgment is hereby granted.<sup>2</sup>

---

22  
23  
24  
25  
26 <sup>2</sup> This ruling (the "Order") constitutes the Court's findings of fact and conclusions of law pursuant to Rule 7052 of  
the Federal Rules of Bankruptcy Procedure.

1     **I.    BACKGROUND**

2           A. The Property Value, Liens and the Homestead Exemption

3           On June 30, 2015, Debtor purchased her home located at 154 W. Soaring Ave.  
4 Prescott, AZ 86301 (the “Property”).<sup>3</sup> According to a residential property brokers’ price  
5 opinion, the Property is valued at \$475,000.<sup>4</sup> According to Debtor’s counsel, Debtor’s  
6 broker has listed the Property for sale at \$475,000. Debtor’s counsel filed on July 9, 2020,  
7 a motion to sell the Property (“Debtor’s Sale Motion”) to an arm’s length 3<sup>rd</sup> party buyer  
8 for \$475,000.<sup>5</sup>

9           Bank of America (“BofA”) holds a \$371,350<sup>6</sup> secured first-priority lien against the  
10 Property. The IRS filed a lien against the Property for unpaid taxes plus a penalty of  
11 \$19,915 for the tax year 2015.<sup>7</sup> Although the tax itself has now been satisfied, the penalty  
12 remains unpaid as does accrued interest in the amount of \$4,771.<sup>8</sup> The Tax Lien now totals  
13 \$24,686.<sup>9</sup> The pre-bankruptcy Tax Lien was recorded by the IRS and it now holds a 2<sup>nd</sup>  
14 (but involuntary) lien position against the Property.<sup>10</sup>

15  
16           B. Procedural History

17           On January 30, 2019 (“Petition Date”), Debtor filed her chapter 7 bankruptcy  
18 case.<sup>11</sup> In her Bankruptcy Schedules, Debtor disclosed her ownership of the Property as  
19

20           

---

<sup>3</sup> DE 34, page 2. “DE” references a docket entry in this Adversary Proceeding 3:20-ap-0038-DPC.

21           <sup>4</sup> DE 34, page 3.

22           <sup>5</sup> Administrative. DE 82. “Administrative DE” references a docket entry in the administrative bankruptcy case 3:19-  
23 bk-01074-DPC. The Trustee filed a limited objection. Administrative DE 88. A hearing on Debtor’s Sale Motion is  
24 set for July 22, 2020 at 11:00 a.m.

25           <sup>6</sup> DE 34, page 2.

26           <sup>7</sup> DE 23, page 2.

<sup>8</sup> It is unclear whether the interest portion of the Tax Lien is wholly attributable to the unpaid penalty or is in some  
measure attributable to interest which had accrued on the principle balance of the IRS’s tax claim. What is clear is that  
the principle balance of the IRS’s tax claim (i.e. the tax itself) has been fully satisfied and is not a part of the Tax Lien.

<sup>9</sup> DE 32, page 3.

<sup>10</sup> DE 22, page 2. Because BofA holds a first position lien totaling \$371,350 and the Tax Lien is \$24,686.26, the  
potential value of Debtor’s homestead exemption appears to be approximately \$83,964.

<sup>11</sup> Administrative DE 1.

1 well as the IRS's claim.<sup>12</sup> On Schedule C,<sup>13</sup> pursuant to A.R.S. § 33-1101(A), Debtor  
2 claimed an exemption of \$150,000 in the Property.

3 On February 27, 2019, Debtor filed a Motion to Compel Abandonment of Property  
4 ("Motion to Compel Abandonment") arguing there was no equity in the Property above  
5 her homestead exemption.<sup>14</sup> The Trustee objected to Debtor's Motion to Compel  
6 Abandonment because Debtor's § 341 meeting had not occurred and Debtor did not have  
7 an allowed exemption but, rather, an "asserted exemption" in the Property.<sup>15</sup>

8 On April 19, 2019, the Trustee filed his Objection to Exemptions ("Objection to  
9 Exemptions").<sup>16</sup> Debtor responded,<sup>17</sup> and Trustee replied.<sup>18</sup> Following the § 341 meeting,  
10 this Court denied the Objection to Exemptions and allowed Debtor's homestead  
11 exemption in the Property, clarifying that the homestead exemption is subordinate to  
12 BofA's mortgage lien and the Tax Lien.<sup>19</sup>

13 On July 3, 2019, Trustee filed a Motion to Authorize the Listing and Sale of Real  
14 Property ("Trustee's Motion to Sell").<sup>20</sup> Debtor objected to Trustee's Motion to Sell.<sup>21</sup>  
15 This Court held a preliminary hearing at which time the Court encouraged the parties to  
16 continue (or revitalize) settlement discussions.<sup>22</sup>

17 On December 27, 2019, BofA filed a Motion for Relief from the Automatic Stay  
18 ("Motion for Stay Relief"). BofA seeks to foreclose its lien on the Property.<sup>23</sup> The Trustee  
19 objected to BofA's Motion for Stay Relief because Trustee's Motion to Sell was still  
20

---

21 <sup>12</sup> DE 34, page 2.

22 <sup>13</sup> DE 34, page 2.

23 <sup>14</sup> Administrative DE 11, page 2.

<sup>15</sup> Administrative DE 22, page 2. The Court has not ruled on the Motion to Compel Abandonment but, in view of this Order, now hereby denies the Motion to Compel Abandonment.

<sup>16</sup> Administrative DE 25.

<sup>17</sup> Administrative DE 26.

24 <sup>18</sup> Administrative DE 28.

<sup>19</sup> Administrative DE 38.

25 <sup>20</sup> Administrative DE 42.

<sup>21</sup> Administrative DE 53.

26 <sup>22</sup> Administrative DE 56.

<sup>23</sup> Administrative DE 58.

1 pending.<sup>24</sup> Debtor also objected to BofA's Motion for Stay Relief because Debtor claimed  
2 to be current on her payments and that BofA's interests were adequately protected.<sup>25</sup> This  
3 Court held a preliminary hearing on BofA's Motion for Relief from Stay and continued  
4 the hearing to May 15, 2020.<sup>26</sup>

5 On February 21, 2020, Trustee initiated this Adversary Proceeding.<sup>27</sup> The  
6 Complaint seeks this Court's declaration that the Trustee can avoid the Tax Lien under  
7 § 724(a) and that the value of the avoided Tax Lien is preserved for the benefit of the  
8 estate.<sup>28</sup> The IRS filed an answer to Trustee's Complaint, disputing Trustee's ability to  
9 avoid the Tax Lien for the benefit of the estate.<sup>29</sup> Debtor filed a Motion for Leave to  
10 Intervene ("Motion to Intervene")<sup>30</sup> which the Court granted.<sup>31</sup> Debtor subsequently filed  
11 her answer to Trustee's Complaint. Debtor argues her allowed homestead exemption  
12 removes the Property from this bankruptcy estate and any recovery from the avoided Tax  
13 Lien belongs to Debtor.<sup>32</sup>

14 On March 26, 2020, Trustee filed a Motion to Approve Sale of Real Property  
15 ("Trustee's 2<sup>nd</sup> Sale Motion").<sup>33</sup> The IRS objected to the Trustee's 2<sup>nd</sup> Sale Motion.<sup>34</sup> At  
16 the hearing on April 7, 2020, the parties advised the Court that there was no pending buyer.  
17 Debtor's Sale Motion is set for hearing on July 22, 2020.

18 The Trustee filed his Motion for Summary Judgment and Statement of Facts  
19 ("TSOF") on April 10, 2020.<sup>35</sup> Both the IRS and Debtor filed responses.<sup>36</sup> The Trustee  
20

---

21 <sup>24</sup> Administrative DE 60.

22 <sup>25</sup> Administrative DE 61.

23 <sup>26</sup> Administrative DE 65. That preliminary hearing has since been continued to August 14, 2020 at 10:30 a.m.

24 <sup>27</sup> DE 1.

25 <sup>28</sup> DE 1, page 3.

26 <sup>29</sup> DE 11, page 4.

<sup>30</sup> DE 13.

<sup>31</sup> Administrative DE 76.

<sup>32</sup> DE 27, page 2.

<sup>33</sup> Administrative DE 66.

<sup>34</sup> Administrative DE 73.

<sup>35</sup> DE 21.

<sup>36</sup> DE 31, 33.

1 replied. On June 5, 2020, the IRS filed a Motion for Leave to Present a Limited Sur-Reply  
2 (“Motion for Sur-Reply”), and Trustee filed his objection.<sup>37</sup> This Court granted the IRS’s  
3 Motion for Sur-Reply.<sup>38</sup>

## 4 5 **II. JURISDICTION**

6 Pursuant to 28 U.S.C. §§ 157(b)(2)(A), (B), (K), and (O), this Court has jurisdiction  
7 over the matters presented by the parties.

## 8 9 **III. ISSUES**

- 10 A. May the Trustee avoid the Tax Lien under § 724(a) and preserve the value of  
11 the avoided Tax Lien for the benefit of the bankruptcy estate under § 551?  
12 B. If the Trustee may avoid the Tax Lien, may the Debtor claim the avoided Tax  
13 Lien as exempt pursuant to §522(g)?  
14 C. If the Trustee may avoid the Tax Lien and defeat the Debtor’s §522(g) claimed  
15 exemption, may the IRS satisfy its unsecured (but possibly nondischargeable)  
16 claim from the exemption proceeds from the sale of the Debtor’s homestead?  
17

## 18 **IV. ANALYSIS**

### 19 **A. Standard for Summary Judgement**

20 Under Fed.R.Civ.P. 56 (made applicable to adversary proceedings by  
21 Fed.R.Bankr.P. 7056), summary judgement is appropriate only “if the pleadings,  
22 depositions, answers to interrogations, and admissions on file, together with the affidavits,  
23 if any, show that there is no genuine issue of material fact and the moving party is entitled  
24 to judgment as a matter of law.” *Celotex Corp. v. Catrett*, 477 U.S. 317 (1986).

25  
26 

---

<sup>37</sup> DE 42, 45.

<sup>38</sup> DE 46.

1           **B. Lien Avoidance under § 724(a) and Preservation of the Avoided Lien For**  
2           **the Benefit of the Estate.**

3           Under § 724(a), a chapter 7 trustee may avoid a lien securing a claim of the kind  
4 specified in § 726(a)(4). The type of claim specified in § 726(a)(4) is:

5           any allowed claim, whether secured or unsecured, for any fine or forfeiture  
6           or for multiple, exemplary, or punitive damages, arising before the earlier of  
7           the order for relief or the appointment of a trustee...

8           Read together, §§ 724(a) and 726(a)(4) allow a chapter 7 trustee to avoid a lien to the  
9 extent the lien secures the claim for a penalty, including a tax penalty.

10           The purpose behind section 724(a) is to protect innocent creditors from the  
11 consequences of the debtor's wrongdoing. The types of claims that are  
12 subject to lien avoidance under section 724(a) are obligations that were  
13 created in order to punish the debtor for the debtor's wrongful conduct. The  
14 debtor will not be punished, however, if those claims are paid in the  
15 bankruptcy case through the proceeds of liens that secure those claims. To  
16 the contrary, payment of those claims, which may not be dischargeable in the  
17 case, could serve to benefit the debtor who is getting his or her other debts  
18 discharged.<sup>39</sup>

19           In the words of the United States Supreme Court, "[t]ax penalties are imposed at least in  
20 part as punitive measures against persons who have been guilty of some default or wrong.  
21 Enforcement of penalties against the estates of bankrupts, however, would serve not to  
22 punish the delinquent taxpayers, but rather their entirely innocent creditors." *Simonson v.*  
23 *Grandquist*, 369 U.S. 38, 82 S. Ct. 537, 539 (1962). Where the penalty portion of tax liens  
24 are avoided and preserved for the benefit of creditors, "the estate is enriched while the IRS  
25 still obtains the principle portion of its liens, with interest, in the order and priority of each  
26 respective lien." *In re Bolden*, 327 B.R. 657, 665 (Bankr. C. D. Cal. 2005) (bankruptcy  
court refused to order the abandonment of debtor's exempt homestead where IRS penalty  
tax liens could be avoided for the benefit of the bankruptcy estate.)

---

<sup>39</sup> Collier on Bankruptcy, 16<sup>th</sup> Edition, page 724-8, 724.02[6].

1 Here, the IRS holds a secured claim of the kind specified in § 726(a)(4).<sup>40</sup> The  
2 IRS's Tax Lien is against the Property, a residence which the Debtor claimed exempt.<sup>41</sup>  
3 The Court granted that exemption over the Trustee's objection.<sup>42</sup> If the Trustee is  
4 permitted to avoid the Tax Lien, § 551 notes that the lien "is preserved for the benefit of  
5 the estate but only with respect to property of the estate."<sup>43</sup> Much of the Debtor's and  
6 IRS's opposition to the Trustee's Motion for Summary Judgment argues that the Property  
7 is not property of this chapter 7 estate and, therefore, § 551 is inapplicable. They argue  
8 that, once this Court allowed Debtor's exemption on the Property, the Property was  
9 removed from the bankruptcy estate and, therefore, the Trustee cannot preserve the  
10 avoided Tax Lien for the benefit of the estate under § 551.

11 Section 541 defines property of the estate as "all legal or equitable interests of the  
12 debtor in property as of the commencement of the case." Notwithstanding § 541, § 522(b)  
13 allows an individual debtor to exempt property from the bankruptcy estate. "By claiming  
14 property as exempt, a debtor removes the property from the estate and places it beyond the  
15 reach of creditors... Once property is exempted, its status as property of the estate is  
16 terminated and the property is ultimately revested in the debtor." *In re Heintz*, 198 B. R.  
17 581, 585 (9<sup>th</sup> Cir. BAP 1996). The *Heintz* court went on to conclude that "§ 551 does not  
18 exclude exempt property from preservation" and that "[a]n avoided interest or lien  
19 encumbering exempt property is automatically preserved for the benefit of the estate under  
20 § 551." <sup>44</sup>

21 A debtor cannot exempt the asset in its entirety from the estate. See *Schwab v.*  
22 *Reilly*, 560 U.S. 770 (2010). In *Schwab*, the Supreme Court recognized that, in the context

---

24 <sup>40</sup> Assuming no portion of the Tax Lien pertains to interest on the underlying principal balance of the IRS's tax claim.

25 <sup>41</sup> Administrative DE 8 at page 10.

26 <sup>42</sup> Administrative DE 38.

<sup>43</sup> § 551 states: "Any transfer avoided under section ... 724(a) of this title ... is preserved for the benefit of the estate  
but only with respect to property of the estate." (emphasis added)

<sup>44</sup> *Id.* at 586.



1 of federal exemptions under § 522(d), the “property” a debtor “may claim as exempt” is  
2 defined as the debtor’s “interest” – up to a specified dollar amount – in the asset, not the  
3 asset itself. *Id.* at 782. Although *Schwab* was dealing with federal exemptions, similar  
4 limiting language is present in the applicable Arizona exemption statute. As discussed in  
5 further detail below, A.R.S. § 33-1101(A) limits a debtor’s homestead exemption to a  
6 \$150,000 interest in a debtor’s residence. A debtor’s allowed homestead exemption does  
7 not remove the entire homestead from property of the estate and instead removes, at most,  
8 the value of a debtor’s interest in the homestead up to \$150,000.

9 In the 9<sup>th</sup> Circuit Bankruptcy Appellate Panel (“BAP”) case of *In re Heintz*,<sup>45</sup> the  
10 debtor consented to the sale of his exempt property as did the debtor’s brother, a creditor  
11 secured by a judgment lien against that property. The brother’s judgment lien was avoided  
12 through the trustee’s stipulation with the brother that acknowledged that the avoided lien  
13 was preserved for the benefit of the estate under § 551. Like the Debtor and IRS in the  
14 case at bar, the debtor in *Heintz* argued the trustee could not preserve the avoided lien for  
15 the benefit of the estate because § 551 is limited to liens that encumber property of the  
16 estate. Over the debtor’s demand that the trustee deliver the sales proceeds to him, the  
17 BAP held that proceeds from the sale of the exempt property belonged to the bankruptcy  
18 estate, not the debtor, because those proceeds were subject to the estate’s lien under § 551  
19 once the trustee avoided the brother’s judgment lien.

20 While *Heintz* does not resolve the Trustee’s dispute with the IRS in the case at  
21 bar,<sup>46</sup> the BAP does tell us that property cannot be exempted from a bankruptcy estate  
22 unless it is first property of the estate.<sup>47</sup> Given all exempt property is property of the estate  
23 at the commencement of a case, the *Heintz* court held “§ 551 does not exclude exempt

---

24 <sup>45</sup> *In Re Heintz*, 198 B.R. 581, 586 (9<sup>th</sup> Cir. BAP 1996).

25 <sup>46</sup> Among other things, *Heintz*, like *Gill* (discussed below) did not address the interplay between § 551 and  
§§ 522(c)(2)(B) and (g).

26 <sup>47</sup> Where there is no controlling decision from the District Court for the District of Arizona, this Court follows the 9<sup>th</sup>  
Circuit BAP’s opinions. See *In re Sample*, 2013 WL 3759795 (Bankr. D. Ariz. 2013).

property from preservation for the estate.” *Id.* at 586. All exempt property must be property of the estate at the commencement of a debtor’s bankruptcy. Here, the Property was property of this estate at the commencement of Debtor’s bankruptcy case. As in *Heintz*, in this case, § 551 applies to the Trustee’s efforts to avoid the IRS’s Tax Lien.

There is another reason why the Property is property of this bankruptcy estate for § 551 purposes, even after the Court allowed the Debtor’s exemption on the Property. Under Arizona’s homestead statutes, the Debtor’s homestead exemption begins where the voluntary BofA lien and the involuntary IRS Tax Lien end. A.R.S. § 33-1101(A) allows any person over the age of 18 who resides within the State of Arizona to

hold as a homestead exempt from attachment, execution and forced sale, not exceeding one hundred fifty thousand dollars in value any one of the following:

1. the person’s interest in real property in one compact body upon which exists a dwelling house in which the person resides... (emphasis added)

When this Court approved the Debtor’s exemption on the Property, what was exempted was only the Debtor’s interest in the Property and then only to the extent of the value of that interest, up to \$150,000. It was only the value of the Debtor’s interest that was removed from this bankruptcy estate and only then once the Debtor’s homestead exemption claim was approved by this Court.<sup>48</sup> The value of the Debtor’s interest in the Property, at all times, was no greater than the value of the Property, less the voluntary BofA lien granted by the Debtor against the Property and less the involuntary lien held by the IRS. This Court said as much in its Order<sup>49</sup> denying the Objection to Exemptions.

---

<sup>48</sup> See *In Re Gebhart*, 621 F. 3d 1206, 1210 (9<sup>th</sup> Cir, 2010) (“By it’s plain language, the Arizona homestead exemption thus appears to track the federal exemption in applying only to an interest up to a given monetary amount.”)

<sup>49</sup> Administrative DE 38.

1 Several statutes and cases must be reviewed to explain this Court's conclusion.  
2 First, A.R.S. § 33-1103(A) notes that a homesteaded property  
3 is exempt from process and from sale under a judgment or lien, except:  
4 1. a consensual lien, including a mortgage or deed of trust, or contract of conveyance.  
5 A.R.S. § 33-1104(D) also tells us that,  
6 [a]ny recorded consensual lien, including a mortgage or deed of trust,  
7 encumbering homesteaded property shall not be subject to or affected by the homestead claim or exemption.  
8 Together, these two statutes reveal that the value of the Debtor's interests in the Property  
9 (i.e. the Debtor's homestead exemption) does not include the value of the Property which  
10 is encumbered by BofA's lien.

11 But what about the value of the Property which is encumbered by the Tax Lien?  
12 The Arizona homestead exemption statutes indicate that such involuntary liens against a  
13 debtor's homestead are "exempt from attachment, execution and forced sale." However,  
14 federal tax lien law provides a crucial element to this discussion. 26 U.S.C. § 6321 creates  
15 a lien in favor of the IRS against all of a taxpayer's property.<sup>50</sup> The 9<sup>th</sup> Circuit long ago  
16 recognized that:

17 [a]gainst such [federal tax] liens, exemptions prescribed by State laws are  
18 ineffective. Bankruptcy does not invalidate such liens or prevent their  
19 enforcement. Section 6 [of the Bankruptcy Act] recognizes exemptions  
20 prescribed by State laws but does not render such exemptions effective  
21 against Federal tax liens.<sup>51</sup>

22 Like the Bankruptcy Act of yesteryear, the Bankruptcy Code today also recognizes  
23 Arizona's exemption laws<sup>52</sup> but does not make such exemptions effective against the IRS's

---

24 <sup>50</sup> Section 6321 states: "If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount  
25 (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may  
26 accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether  
real or personal, belonging to such person."

<sup>51</sup> *United States v. Heffron*, 158 F. 2d 657 (9<sup>th</sup> Cir. 1947).

<sup>52</sup> See § 522(b)(2) (permitting states to opt out of the federal exemption scheme) and A.R.S. § 33-1133(B) (Arizona  
has opted out of the federal exemption scheme found at § 522(d)).

1 Tax Lien. A claim of exemption, by itself, does not affect the validity of liens on the  
2 property claimed as exempt. *See In re DeMarah*, 62 F.3d 1248, 1251 (9th Cir. 1995)  
3 (stating “it is pellucid that property exempted from the estate remains subject to tax liens”).

4 Under a similar, but not identical, fact pattern the BAP held that a trustee’s ability  
5 to avoid the penalty portion of a federal tax lien under § 724(a) and to preserve that  
6 avoided lien under § 551 for the benefit of the estate precluded abandonment of the estate’s  
7 property encumbered by that lien.<sup>53</sup> In *Gill*, the debtor moved to compel the trustee to  
8 abandon his residential property. The debtor claimed the property was of inconsequential  
9 value to the estate in light of the magnitude of the debtor’s claimed homestead exemption  
10 plus the mortgage lien plus the IRS’s tax lien.<sup>54</sup> The BAP held the trustee could avoid the  
11 penalty portion of the IRS tax lien under § 724(a) for the benefit of the estate, thereby  
12 creating value for unsecured creditors when that avoided lien was preserved for the benefit  
13 of creditors under § 551.

14 At the commencement of this bankruptcy case, property of this estate included the  
15 entire value of the Property. When the Court approved the Debtor’s homestead exemption  
16 it was only the value of the Debtor’s interest in the Property which was removed from the  
17 bankruptcy estate. The value of the Debtor’s interest in the Property never included the  
18 value of the lien positions occupied by BofA or the IRS. Instead, here the Debtor’s  
19 homestead exemption is third in line, behind BofA’s 1<sup>st</sup> lien and the 2<sup>nd</sup> position occupied  
20 by the IRS’s Tax Lien. The Debtor’s homestead exemption is ineffective against the IRS’s  
21 Tax Lien. In other words, it is the Debtor’s equity in the Property which is exempt, and  
22 that equity position is subordinate to both the BofA lien and the Tax Lien.

---

24 <sup>53</sup> *In re Gill*, 574 B.R. 709 (9th Cir. BAP 2017). *See also In re Savage*, 216 B.R. 919, 920 (Bankr. S.D. Ga. 1997)  
25 (stating trustee can avoid a portion of the IRS lien for penalties and statutory additions that secured a claim of the kind  
specified in § 726(a)(4)).

26 <sup>54</sup>After considering the value of the home, the first position mortgage, and the IRS’s tax lien, the *Gill* court noted the  
debtor had no equity in the residence. Debtor’s residence was valued at \$500,000. There was a \$371,00 first position  
mortgage, and an IRS secured claim for \$161,530, including \$48,276.33 in tax penalties.

1 At all relevant times, the IRS's Tax Lien encumbered property of this estate. The  
2 trustee may avoid the IRS's Tax Lien under § 724(a). Upon avoidance of the IRS's Tax  
3 Lien, the IRS's Tax Lien is preserved for the benefit of this bankruptcy estate under § 551.  
4 Here, like *Gill*, the Trustee has the power to avoid the IRS's Tax Lien under § 724(a) to  
5 the extent the Tax Lien secures penalties and interest on those penalties. Also, like the  
6 trustee in *Gill*, the Trustee may preserve this avoided lien under § 551. Moreover, once  
7 the Tax Lien is avoided, the Trustee "...inherits the position of the entity whose lien was  
8 avoided."<sup>55</sup> As will be seen below, that "position" includes the special powers afforded  
9 the IRS's Tax Lien under § 522(c)(2)(B).

10 *Gill*, however, did not address all the issues before this Court because the *Gill* court  
11 was not asked to determine the impact §§ 522(c)(2)(B) and (g) have upon a lien which is  
12 avoided under § 724(a) and preserved under § 551. The next questions before this Court,  
13 therefore, are whether the avoided IRS Tax Lien is preserved for the benefit of the estate  
14 or the Debtor and what rights are held by the IRS after its Tax Lien is avoided.

15  
16 **C. § 522(g), § 522(c)(2)(B) and the Power of Avoided Tax Liens.**

17 In certain instances, a debtor may exempt property preserved by the Trustee under  
18 § 551. Section 522(g) states:

19 the debtor may exempt under subsection (b) of this section property that the  
20 trustee recovers under section ...551 ... of this title, *to the extent that the*  
*debtor could have exempted such property* under subsection (b) of this  
21 section if such property had not been transferred, if --

22 (1) (A) such transfer was not a voluntary transfer of such property by the  
debtor; and

23 (B) the debtor did not conceal such property ...  
(emphasis added)

24 Once a trustee avoids a lien that was not voluntarily created by the debtor, the debtor may  
25 claim the value of the lien as exempt so long as the debtor did not conceal the property.

26 <sup>55</sup> Colliers at § 551.02, page 551-4.

1 Here, the Debtor did not voluntarily grant the IRS the Tax Lien. Moreover, the Debtor  
2 disclosed to the Court both the Property and the Tax Lien.

3 *In re Hannon*, 514 B.R. 69 (Bankr. D. Mass. 2014) is cited by the Debtor and the  
4 IRS as the principle case supporting the proposition that avoidance and preservation of the  
5 Tax Lien by the Trustee will result in the Debtor's allowed exemption stepping into the  
6 lien position recovered and preserved by the Trustee. In *Hannon*, the IRS had a tax lien  
7 on all of the chapter 7 debtors' real and personal property. The debtors claimed an  
8 exemption on all the property, but the IRS lien was greater than the value of the property  
9 claimed exempt. The chapter 7 trustee sold all of the property<sup>56</sup> and then filed an adversary  
10 proceeding seeking, under § 724(a), to avoid that portion of the IRS's lien attributable to  
11 penalties and interest on the tax penalties and then seeking to preserve the avoided lien for  
12 the benefit of the bankruptcy estate under § 551. The court correctly recognized that the  
13 value of debtor's exemption was \$0 because the amount of the IRS's lien exceeded the  
14 value of the property claimed exempt. The court also properly acknowledged that the  
15 exempt property remained property of the bankruptcy estate notwithstanding the  
16 magnitude of the IRS's lien and the fact that the debtor had claimed the property exempt.<sup>57</sup>  
17 Bankruptcy Judge Hillman also accurately cited the 9th Circuit's *DeMarah* decision for  
18 the proposition that the Hannon could not themselves avoid the IRS's tax lien and  
19 preserve that avoided lien for the debtors. Without explaining its rationale, however, the  
20 court ultimately concluded:

21  
22  

---

<sup>56</sup> The trustee's sales were with the consent of the IRS and without any objection from the debtors.

23 <sup>57</sup> In dicta at footnote 36 Judge Hillman stated:

24 [i]f The Debtors wished to deal with the IRS outside of their bankruptcy case, as they insist, the  
25 Debtors could have objected to the sale and moved for the trustee to abandon the property. They  
26 failed to do so.

25 In this Court's estimation Judge Hillman's observation unnecessarily goes too far by assuming there could be no  
26 benefit to the estate under this fact pattern. As will be discussed in greater detail below, this Court finds that,  
notwithstanding § 522(g), the bankruptcy estate will indeed benefit from the Trustee's avoidance of the Tax Lien and  
preservation of that lien for the benefit of the estate.

1 ...that, even if the Trustee is successful in the Avoidance Action, the entirety  
2 of its tax lien will survive as to the property claimed as exempt. Pursuant to  
3 § 522(g), if the Trustee avoids the IRS lien on property in which the Debtors  
4 have claimed an exemption, the value of the avoided lien will accrue first to  
5 the Debtors exemption, not to the estate. Thus, once the Avoidance Action is  
6 completed, there may be sale proceeds which are exempted from the  
7 bankruptcy estate. Then, pursuant to § 522(c)(2)(B), any exempt portion of  
8 the sale proceeds would be liable for the entirety of the IRS lien, not solely  
9 for the non-penalty portion. Nevertheless, only if the Trustee succeeds in the  
10 Avoidance Action will any of these sale proceeds become exempt property.<sup>58</sup>

11 As will be explained below, this Court disagrees with (and, of course, is not bound  
12 by) *Hannon's* conclusion that, under § 522(g), a debtor's exemption will displace the  
13 Trustee when he avoids the Tax Lien on the Property and seeks to preserve that Tax Lien  
14 for the benefit of the estate.

15 On its face, § 522(g) appears to allow the Debtor to exempt any avoided penalty  
16 lien. However, § 522(c)(2)(B) limits a debtor's right to invoke § 522(g) when a lien is  
17 avoided, and the property preserved by the trustee is a tax lien. Section 522(c)(2)(B) states:

18 property exempted under this section is not liable during or after the case for  
19 any debt of the debtor that arose . . . except – a debt secured by a tax lien,  
20 notice of which is properly filed.

21 *In re DeMarah* is a case that is factually distinguishable but nevertheless important  
22 to the disposition of the case at bar. In *DeMarah*, the debtor attempted to avoid a federal  
23 lien to the extent the lien was for tax penalties and then tried to preserve the avoided lien  
24 for the debtor's benefit. The debtor argued § 522(h)<sup>59</sup> allowed him to avoid the lien because  
the trustee had not done so under § 522(g). The 9<sup>th</sup> Circuit noted that § 522(i)(2) conditions  
the debtor's preservation of an avoided lien on the debtor's avoidance of such lien under  
§522(h). However, § 522(h) contains the same limiting language as § 522(g) – *to the extent*

---

25 <sup>58</sup> *Hannon* at 79.

26 <sup>59</sup> Section 522(h) states: The debtor may avoid a transfer of property of the debtor... to the extent that the debtor could have exempted such property under subsection (g)(1) of this section if the trustee had avoided such transfer, if- (1) such transfer is avoidable by the trustee under section...724(a) of this title...and (2) The trustee did not attempt to avoid such transfer.

1 *that the debtor could have exempted such property.* The 9<sup>th</sup> Circuit found § 522(c)(2)(B)  
2 precludes a debtor from ever invoking § 522(h) to avoid a tax lien. For this reason, a debtor  
3 cannot receive the benefit of an avoided tax lien under § 522(i)(2). Rejecting the debtor's  
4 arguments, the 9th Circuit held § 522(c)(2)(B) prevents the debtor from avoiding the tax  
5 lien under § 522(h) and then preserving the avoided lien under § 522(i)(2).<sup>60</sup>

6 *DeMarah* explained that the purpose of allowing a trustee to avoid a tax lien for  
7 penalties is “to benefit unsecured creditors.” Unsecured creditors would be unprotected if  
8 debtors could gain the benefit of avoiding penalties they incur. The court concluded,  
9 “Congress has not allowed debtors to avoid all blemishes wrought by their past deeds . . .”  
10 “[o]ne of those blemishes is caused by the failure to pay taxes.”<sup>61</sup>

11 The principal difference between *DeMarah* and the case before this Court is that  
12 here the Trustee, not the Debtor, seeks to avoid the Tax Lien and preserve the avoided lien  
13 for the benefit of the estate's creditors and not for the benefit of the Debtor. However, the  
14 9th Circuit recognized that while “§ 522(c)(2)(A) indicates that a debt secured by a lien  
15 that is avoided pursuant to § 724(a) does not remain attached to the exempt property ...  
16 § 522(c)(2)(B)...brings back the whole of any tax lien.”<sup>62</sup> Section 522(c)(2)(B) does not  
17 distinguish between § 724(a) lien avoidance by a trustee or a debtor. Section 522(g) is not  
18 available to the debtor unless “the debtor could have exempted such property.” Section  
19 522(c)(2)(B) prevents the debtor from exempting that portion of the property encumbered  
20 by the IRS tax lien. As in *DeMarah*, § 522(c)(2)(B) blocks the Debtor's ability to co-opt a  
21 tax lien otherwise avoidable under § 724(a). Liens for tax penalties and interest on those  
22 penalties may be avoided under § 724(a) but only for the benefit of the estate's creditors.  
23 *DeMarah* and § 522(c)(2)(B) compel this result. To hold otherwise would enable a Debtor

---

24 <sup>60</sup> Section 522(i)(2) states: “Notwithstanding 551 of this title, a transfer avoided under section ...724(a) of this title,  
25 under subsection (f) or (h) of this section. . . *may be preserved for the benefit of the debtor* to the extent that the debtor  
may exempt such property under subsection (g) of this section or paragraph (1) of this subsection.” (Emphasis added.)

26 <sup>61</sup> Id at 1252.

<sup>62</sup> *DeMarah* at 1252.



1 to wrongfully fail to pay her tax bill and then use § 522(g) to claim the avoided tax penalty  
2 lien for herself and to the detriment of her creditors. This is not what § 724(a) was designed  
3 to accomplish nor what § 522(c)(2)(B) mandates nor what the 9<sup>th</sup> Circuit would  
4 countenance. This Court finds that, read together, §§ 522(g) and 522(c)(2)(B) prohibit a  
5 debtor from claiming an exemption in the recovery of a tax lien avoided by a trustee under  
6 § 724(a) and preserved estate under § 551.

7 Two decades after *DeMarah*, a fellow 9<sup>th</sup> Circuit bankruptcy judge had occasion to  
8 address the tension between § 522(c)(2)(B) and a debtor's homestead exemption.<sup>63</sup> In  
9 *Hutchinson*, the debtors brought an adversary proceeding to avoid the penalty portion of  
10 the IRS's tax lien on their homestead. The court held that "debtors cannot . . . preserv[e]  
11 a tax lien for their benefit" because § 522(c)(2)(B) precludes a debtor from avoiding the  
12 IRS tax lien.<sup>64</sup> There, the court held § 551 controls the preservation right as to the IRS  
13 tax lien avoided by the trustee. The court also noted that, where the lien sought to be  
14 avoided secures back taxes, § 522(c)(2)(B) eviscerates the debtor's avoidance power and  
15 brings back the whole of any tax lien notwithstanding §§ 724(a) or 726(a)(4). The avoided  
16 lien is preserved for the benefit of the estate. *See also 4 Collier on Bankruptcy* ¶ 522.12  
17 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. rev. 2012) (under § 551, transfers are  
18 preserved for the benefit of the estate, while under § 522(i)(2) transfers are preserved for  
19 the benefit of the debtor).<sup>65</sup>

20 Finally, the IRS and Debtor both complain that, if the IRS's tax lien is avoided by  
21 the Trustee and preserved only for the estate's benefit, then the Debtor will, in effect, pay  
22 twice on the IRS claim because the IRS will be able to then seize homestead sale proceeds  
23

---

24 <sup>63</sup> *In re Hutchinson*, 579 B.R. 860, (Bankr. E.D. Cal. 2018).

24 <sup>64</sup> *Id.* at 864.

25 <sup>65</sup> In an unpublished memorandum decision, the 9<sup>th</sup> Circuit BAP affirmed the bankruptcy court's  
26 decision and held: "Generally, debtors can assert exemption rights on property avoided by the trustee  
pursuant to § 522(g). However, where the avoided transfers are liens securing tax penalties, Debtors  
cannot claim an exemption on the property secured by the liens."

1 to the extent those proceeds would otherwise be exempt. The Court disagrees that the  
2 Debtor will be unfairly docked twice on the IRS claim. The Tax Lien position against the  
3 Property never attached to the Debtor's homestead exemption. As explained above, the  
4 value of the Debtor's exemption was always subordinate to the Tax lien. When the Tax  
5 Lien is avoided, the Trustee steps into that avoided position. If it so happens that the IRS's  
6 now unsecured claim is also nondischargeable, it is no different than any other  
7 nondischargeable claim which will need to be paid by the Debtor. Whether the IRS can  
8 force payment of its unsecured and nondischargeable claim from exempt proceeds from  
9 the sale of the Property is not an issue ripe for this Court's determination as there are no  
10 sale proceeds yet available for seizure by the IRS.

## 11 12 **V. CONCLUSION**

13 Based on the foregoing, this Court determines there are no genuine issues of  
14 material fact and the Trustee is entitled to entry of summary judgment as a matter of law.  
15 Pursuant to §§ 724(a) and 551, Trustee may avoid the Tax Lien and preserve the value of  
16 the avoided lien for the benefit of the estate. The Debtor is not entitled to reap the benefits  
17 of that avoided Tax Lien. The position of value occupied by the Tax Lien was never  
18 covered by Debtor's homestead exemption and this fact will not be changed by § 522(g)  
19 now that the Trustee steps into the shoes of the avoided Tax Lien. Whether the IRS holds  
20 any rights to any portion of the exempt proceeds from the sale of Debtor's homestead is  
21 another issue for another day. That issue may, in part, turn on whether the now unsecured  
22 IRS claim is nondischargeable.

23 **DATED AND SIGNED ABOVE.**

24  
25 COPY of the foregoing mailed by the BNC and/or  
26 sent by auto-generated mail to interested parties.